

FOCUS ON

# HEDGE FUND MARKETING

Jason Cholewa of ALPS discusses hedge fund marketing and what constitutes broker-dealer status



## Jason Cholewa

heads East Coast business development for ALPS' Alternative Investment Services division. Prior to this, he was instrumental in opening ALPS' Boston office and was responsible for building the staff and overseeing all administration services and operations on the East Coast.

One of the historic benefits of running a US-based investment adviser whose products are hedge funds has been a considerable lack of regulatory requirements compared to other traditional products. As all of us know, regulatory encroachment and the burden it creates for an investment adviser has been increasing over the past several years.

With that said, it is not always new regulations that can cause additional pain. One requirement, which has been flying under the radar for some time, is the issue with individuals that market interests in hedge funds and how those individuals are compensated. It is important to understand when investment adviser employees' actions trigger broker-dealer registration requirements and how those can either be avoided or properly handled.

### WHAT IS THE REQUIREMENT?

The requirement essentially comes down to how a hedge fund (or any security) is marketed. As Section 15(a)(1) of the Securities Exchange Act of 1934 states, if any person acts as a 'broker' or 'dealer' in securities in interstate commerce, then they are required to register as a broker-dealer with the SEC.

But what does it mean to act as a 'broker' or 'dealer'? About a year ago David W. Blass, chief counsel, Division of Trading and Markets for the SEC, made some comments on exactly what the SEC is looking for as this rule relates to hedge funds. If a private fund manager either employs individuals primarily for marketing the fund

or pays transaction-based compensation for selling interests in a fund, then broker-dealer registration may be required.

This isn't a new rule, but there has been increased interest by the SEC in this area as it relates to hedge funds. The SEC has a new initiative where it is increasing presence examinations of new registrants. One area of focus is fees and expenses, and when payments of those fees might create unregistered broker-dealer activity.

About a year ago the SEC took action against an investment adviser and one of its employees because that adviser paid transaction-based compensation to an individual that was soliciting interests in a private fund, and was not properly registered. The employee was paid a percentage of assets raised and his activities included sending private placement memoranda, subscription documents, and due diligence materials to potential investors. He urged at least one investor to adjust his portfolio allocation to allow for an investment in the fund, and he also provided investors with fund strategy and performance information.

Unfortunately, these all sound like fairly common practice activities for marketing or investor relations staff. Most hedge fund investment advisers are not registered as broker-dealers, so how do they get around the rule? They are either out of compliance, outsourcing their broker-dealer activities, or they are utilising an exemption to the rule.

### WHAT ABOUT THE EXEMPTION?

Rule 3a4-1 provides a limited issuer exemption, which may allow an investment adviser and its employees to be exempt from broker-dealer registration. There's a lot that goes into how to utilise the exemption, but generally if the employee of the investment adviser has primary job responsibilities outside of selling interests in the hedge fund, limits his or her activity to institutional contact, and is not compensated based on selling interests in the fund, then the exemption may apply.

A clear example of proper use of the exemption would be the portfolio manager of the fund. It's reasonable to assume the portfolio manager's primary job responsibility is making investment decisions on behalf of the fund and typically, the manager's compensation is based on fund performance, not on the sale of a security. Under this type of scenario, it's generally deemed acceptable for a portfolio manager to speak with prospective investors without the risk of acting as a broker or dealer.

The exemption becomes more questionable when looking at marketing staff of a hedge fund. Is the sole or primary function of the marketing staff to raise capital, or do they have other duties or a different primary function? How are those employees compensated? Do they have a discretionary bonus or is that bonus in some way tied to capital raising? These are the questions that every investment adviser needs to work through with their attorneys to ensure they are in compliance with the rule and are properly utilising the exemption.

### WHAT IF THE EXEMPTION DOES NOT APPLY?

If one or more of the investment adviser's employees cannot rely on the exemption, then that employee will need to acquire a Series 7 or Series 82 licence, register with FINRA, and be affiliated with a broker-dealer. Some hedge fund managers have made the decision to create their own broker-dealer and manage the pro-

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cess internally. Since this can be a burdensome venture, other managers have elected to affiliate with third-party broker-dealers to meet these requirements. Typically in this type of set-up, the third-party broker-dealer acts as placement agent for the fund offerings. The relevant investment adviser employees become licensed with the third-party broker-dealer as a registered representative. This allows those individuals to market the hedge fund and be compensated based on capital they have raised, while allowing the third-party broker-dealer to provide all the compliance oversight required by Finra.

Since Blass's comments a year ago, we've seen heightened awareness to this issue. Because ALPS has a broker-dealer approved for private placement activity and has been overseeing the activities of hundreds of registered representatives for decades, we've been in a unique position to get a feel for industry sentiment. It seems with the SEC focusing on investment adviser marketing activities, a number of hedge fund managers have taken a closer look at their own staff and are re-addressing broker-dealer registration requirements.

This is a trend that has been increasing and does not seem to be slowing down any time soon. It would be prudent for any hedge fund manager that is unsure of their situation to speak with their attorney about potential li-

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ability issues. With at least one major enforcement action against a private fund adviser in the past 12 months, it appears the discussion is not simply an academic one, but a valid area of concern that needs to be addressed. ■